Hughes Aircraft Co., the nation's largest defense electronics contractor, may be sold, and the managers, who have run it like owners for decades, may not like the idea of a new master.

Killing the goose?

By Allan Dodds Frank

IN SPITE OF THE CONTROVERSY over allegedly faulty missiles, mouths are watering on Wall Street because all or part of Hughes Aircraft Co. will almost certainly be up for sale soon—with huge underwriting fees in the offing. For 31 years HAC has been wholly owned by a charity, the Howard Hughes Medical Institute, and autonomously managed by a smart and, according to legend, extremely well-compensated team. The company does not seem to have suffered from its unusual ownership. HAC holds huge bundles of high-technology, high-security contracts and runs nearly $5 billion a year in sales, including $3.2 billion in defense work. Its backlog: $10 billion.

Why is this exceedingly juicy morsel coming on the market? The institute doesn't need more money, but it must spend more money, the IRS says. That means drawing more cash from HAC or losing the institute's tax break. HAC was created when Howard Hughes spun off the electronics division of the Hughes Tool Co. and handed ownership to his namesake medical institute in Delaware in 1953. The suspicion has been that the whole affair was a tax move designed to keep Howard Hughes in sole control while paying no taxes.

Today's IRS regulations say charitable medical research institutes must continuously and actively spend an amount equal to 3.5% annually of their assets. (The rules are much stricter for general purpose foundations, like the Ford Foundation, which passively grant money to outsiders; they are required to spend 5% of the asset base annually, and after

Irving Shapiro, Du Pont ex-chairman and now an institute trustee
"We can't live with the present conditions."

In 1981 the medical institute received $23 million in dividends from HAC; in 1982, $39 million; and in 1983, $51 million. The IRS charges that those amounts, which, in effect, are the institute's budget, are well below 3.5% of the asset value of the company, and it seems to want anywhere from $100 million to $300 million paid to the institute to make up for the past stinginess. Any way you slice it, the company faces a severe cash drain as well as a future ceiling on the amount of cash flow it can retain. By limiting dividends the company was able to finance one of the most extensive research and development programs in modern times, which in turn made HAC into the electronic giant and national asset that it is.

The IRS also contends that the Miami-based institute is more like a foundation than a medical institute and should be subjected to those regulations and thus be paying 5%, not 3.5%—which could mean a need for much larger yearly dividends. In any case, if the IRS has its way, the financial drain might be so great that the company could no longer finance its R&D and expansion programs. So, going public or being sold seems the only way out.

HAC could go to one buyer—selling it piecemeal isn't likely—or go public with an initial offering that could be one of the largest in the history of Wall Street: maybe $2.5 billion, maybe $5 billion.

General Electric Co. of Great Britain, which is no relation to General Electric in the U.S., has been making passes at buying a minority interest, 8% to 20%, of HAC. But HAC management is on record as favoring a public offering and substantial stock purchases by and for employees; that way they could keep control.

An excellent case can be made for continuing the current management, which has performed brilliantly. Moreover, any deal that left Hughes' outstanding scientific teams unhappy and job-hunting would be a bad deal for the buyer. Then, that big customer, the Pentagon, must be happy with any new owner; after all, HAC accounts for 400 separate line items in the federal budget, and foreigners are likely to be a problem.

Who could buy it? Other defense contractors like General Dynamics, Rockwell International, United Technologies, Boeing and Lockheed might be in the bidding. Whoever wants it also must be cash-rich, like General Electric, Ford, IBM or AT&T.

Dr. Donald Fredrickson, a trustee and CEO of HHMI, tells FORBES no decisions have been made and no buyers have yet come forward. The institute's trustees recently auditioned six investment firms before selecting Morgan Stanley to evaluate the company's options.

A state judge in Delaware recently appointed a new set of trustees for the medical institute, including former Du Pont Chairman Irving Shapiro. Says Shapiro, head of the institute's finance committee, "The IRS has sat on it for a long time and just never came to collect its milk. With the new board of trustees, we've got to force the issue and get it resolved. We can't live with the present conditions; it's that simple. We have to get enough cash each year in order to be able to meet the tax laws."

So the big question is when the sale will come. Soon, but not tomorrow. The investigation into faulty Hughes missiles puts the company under a temporary cloud, but the problems are expected to be corrected and Hughes isn't likely to lose any major contracts. Meanwhile, HHMI trustees are still fighting with the IRS over how much money is due to the institute. The trustees don't want to hurt the aircraft company. If the IRS wants too much, they'll fight in court. ■